

TRUST PROTECTORS

When and how should they be used?

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Irrevocable trusts are widely utilized as part of a family wealth transfer plan to achieve a number of tax and non-tax goals alike. The trend is toward longer, if not perpetual, duration irrevocable trusts intended to preserve family wealth for many generations of beneficiaries. And forever, or almost forever, is a very long time.

Wealth owners and their advisors are understandably searching for greater flexibility in these long-term irrevocable trusts to accommodate unanticipated and unforeseeable future events that will affect the intended trust beneficiaries, the property being administered for their benefit, and the world at large. Enter the “trust protector.” Long a staple of international trust planning, domestic interest in trust protectors has grown, as has the number of states that recognize their use. In this *Insights on... Wealth Planning*, we provide an overview of the emerging domestic recognition of trust protectors and when and to what extent they may (or may not) be useful in long-term irrevocable dynasty trust planning.

WHAT IS A TRUST PROTECTOR?

There is no long-standing commonly accepted definition of the role of a trust protector. The trust protector designation is at times used interchangeably with that of a trust advisor. We use the titles separately and distinctly. When we use the term trust protector, we mean an individual (or a succession of individuals) appointed by the settlor of a trust to ensure that the trustee carries out the settlor’s intent behind the establishment of the trust generations in the future, acting as the figurative eyes, ears and voice of the settlor. In this paradigm, the trust protector’s primary responsibility is to oversee the trustee, watching to be sure that the administration of the trust proceeds in accordance with the settlor’s intentions and standing ready to exercise her authority to alter the course of administration when necessary, or simply desirable. A trust protector typically possesses defined limited authority to engage in specified actions, separate and apart from the power and authority of the trustee, such as to remove a trustee, appoint a trustee, add beneficiaries or otherwise modify the terms of a trust.

A “trust advisor,” on the other hand, is the designation more commonly used to describe the role of a person who has the power and responsibility to direct, or perhaps merely advise, a trustee in its actions. The advisor directs or guides the trustee in the trustee’s exercise of its powers. The trust protector acts separate and apart from the trustee with powers the trustee does not have; a subtle, but meaningful, distinction.

The trust protector may play a particularly important role in long-term trusts as the beneficiary generations become more remote from the settlor and the settlor’s original intentions. Planning for the certainty of future changes in circumstances without knowing what the specific changes will be is a pernicious challenge. The judicious use of trust protectors may help guide the trust through these generational changes.

WHAT ARE A TRUST PROTECTOR’S POWERS?

A trust protector’s powers are those provided by applicable state law, if any, and those expressly stated in the governing instrument (subject to any limitations on trust protector powers provided by state law). There are no inherent powers that arise simply by designating a trust protector to act. This makes the choice of law governing a trust and drafting to specify the powers of the trust protector of paramount importance.

States laws, based in many states on the Uniform Trust Code,¹ increasingly include provisions authorizing the appointment of a trust protector.² Indeed, these jurisdictions recognize the utility of a settlor's appointment of a protector as a mechanism to create flexibility in the administration of trusts. Settlers and planners are wise to tread cautiously, for while the authority that can be granted to a trust protector is arguably limitless, the broader the authority the more like a trustee the trust protector becomes, and with it all of the fiduciary responsibilities and liabilities. See the table below for a non-exclusive list of powers that may be granted to a trust protector.

Powers related to the trustee	Powers unrelated to the trustee
Power to remove and replace an acting trustee	Power to change the situs of the trust
Power to appoint additional trustees	Power to change the governing law of the trust
Power to act as a tiebreaker when multiple trustees reach an impasse	Power to terminate the trust under certain defined conditions
Approval authority for discretionary distributions or the sale or management of specific assets	Power to amend the trust for any valid purpose, such as to respond to changes in federal or state tax law
Power to veto decisions made by the trustee	Power to alter the beneficial interests in the trust, such as to add or remove beneficiaries

The essence of a trust protector's powers is the ability to modify a trust instrument that is otherwise irrevocable and may not be amended. Although modern trust law is more receptive to the modification of existing irrevocable trusts, there are often limitations on the circumstances that allow modification and doing so is often a lengthy process requiring the approval of beneficiaries and judicial proceedings. Trust protectors can provide the same flexibility without involving beneficiaries or a court. That being said, there are instances where consents or court guidance may still be desirable.

Powers Related to the Trustee

Trust protectors are frequently named for the specific purpose of removing and replacing an acting trustee, or for appointing additional or successor trustees. Although settlors may give these powers to beneficiaries, the potential abuse of the removal power by the beneficiaries should be considered. An unsatisfied beneficiary's first reaction is to replace a conscientious trustee with one that is more accommodating to the beneficiary's wishes. A trust protector with the ability to remove and replace a trustee can provide an impartial assessment of the trustee's performance and substitute the trustee where appropriate. The settlor then has some assurance that the substitution is necessary and the trustee has some assurance that unpopular decisions will be reviewed objectively and without the need for judicial intervention.

Some protectors may be expected to participate in administrative decisions. For example, a trust protector may act as a tiebreaker when multiple trustees are serving and have reached an impasse, or may hold final authority for approval of discretionary distributions, or the sale or management of specific assets. Whenever multiple trustees are acting there is always potential for disagreement. Enabling a trust protector to mediate these potential disputes as a tie-breaker for evenly divided trustees, or as a veto holder, can ensure the continued functioning of the trust without the necessity of judicial intervention.

Powers Unrelated to the Trustee

The trust protector can also have powers over the trust administration and the beneficial enjoyment of the trust. Powers concerning the trust administration may include the power to change the situs of the trust and governing state law, decant the trust, terminate the trust under defined conditions, and importantly, to amend the trust for any valid purpose, such as in response to changes in federal or state tax law or other changes to state or federal law.

The trust protector may also be given the authority to alter the beneficial interests in the trust. This may include the power to modify the trust terms, including dispositive provisions; grant, remove or approve how the beneficiaries exercise powers of appointment; and even approve termination of the trust. The trust protector could also exercise a power to add or remove beneficiaries or classes of beneficiaries, including charitable ones. In this expansive role, the trust protector's knowledge of the settlor's wishes and the family history may become crucial. It is also in this role that the trust protector can provide significant benefit to a long-term trust.

The protector's power to alter the beneficial interests in the trust may also be beneficial if there is (or may be in the future) a beneficiary that is incapable of handling his or her finances, facing creditor problems, suffering from an alcohol or drug addiction, or would use the distribution for purposes of which the settlor would undoubtedly disapprove. Under such unfortunate circumstances, a trust protector could amend the trust so that a mandatory distribution or right of withdrawal be removed or suspended until the beneficiary's situation has stabilized.

A word of tax caution is in order whenever the powers of a trust protector may be exercised to alter the interests of beneficiaries in a trust. Care should be taken to so as not to cause an unintended gift, estate tax inclusion, or loss of the generation-skipping transfer tax grandfathered or exempt status of a trust.

WHY OR WHY NOT A TRUST PROTECTOR?

From the settlor's perspective, the question of whether to appoint a trust protector is less about what powers a protector may have than why a protector may be desired. It is unlikely that a trust drafted today will remain functional 100, 200 or more years or more from now, as a number of states allow. In considering whether to appoint a trust protector, try to imagine what society was like seven generations ago and what it might be like seven generations into the future. Think of the trust instrument as the written guide of the settlor's intentions for benefitting the chosen beneficiaries, whether known or unknown to the settlor today. Although it is the trustee's duty to follow the terms and purposes of the trust, at some point the terms of the trust as originally drafted may no longer function to fulfill the settlor's original intentions. Indeed, circumstances, laws and family relationships change too often to not require some adjustments.

WHO SHOULD AND SHOULD NOT SERVE AS TRUST PROTECTOR?

Determining whom to appoint as trust protector should be made in the framework of the intended trust protector's scope of responsibilities. As with the selection of a trustee, the specific responsibilities may require certain attributes or skills that would be beneficial or necessary in a trust protector. For example, if the trust protector is to exercise authority to modify the trust to accommodate changes in applicable tax law, one would look for a trust protector with both an understanding of tax law and an appreciation for how it impacts the provisions of the particular trust instrument. If the trust protector's authority is to oversee and provide final approval on a beneficiary's exercise of a power of appointment, one would select a trust protector with an understanding of the family history and dynamics, and the settlor's concerns that prompted the appointment of a trust protector in the first place.

Different powers may call for different trust protectors, or perhaps a committee of trust protectors. Selections can be made from within the family, business partners, close friends, attorneys, accountants, or other professional advisors.

Who Should Not Serve as Trust Protector?

While the trust protector serves as the figurative eyes and ears of the settlor, it is important to be sure that the appointment of a trust protector does not cause adverse tax consequences for the settlor or the trust protector. The trust protector should not be the settlor or any other donor to the trust. If the trust protector is the settlor's spouse or a beneficiary of the trust, and the trust protector has an unrestricted power to remove and replace the trustee, consideration should be given to whether the attribution of the trustee's powers to the trust protector may cause income, gift, or estate tax consequences.

Provide a Mechanism for Succession

As with the appointment of a trustee, it is important to provide for a mechanism for succession of the trust protector. A well drafted trust protector provision will include a section that addresses the death, incapacity, or resignation of the trust protector as well as the appointment of a replacement trust protector. There should be a mechanism for notice to the trustee and possibly beneficiaries that a trust protector can no longer serve and must be replaced. It is probably wise to use the same criteria for determining the incapacity of a trust protector as the trust instrument provides for an individual trustee.

IS A TRUST PROTECTOR A FIDUCIARY?

The answer to this question is neither clear nor consistent. The legal status of a trust protector is still a matter of developing law in the United States and few courts have considered whether a trust imposes a fiduciary duty on the trust protector.³ Whether a trust protector is held to the same fiduciary standards as a trustee is one of the most ardently debated issues surrounding their use.

The Uniform Trust Code establishes a presumption that a trust protector is a fiduciary, but provides that the settlor may modify the presumption by overriding the default rule in the trust instrument. However, the Uniform Trust Code prohibits a trust instrument from reducing a trustee's duty below a minimum standard.⁴

A number of state statutes specify that a trust protector is not a fiduciary unless otherwise specified by the trust instrument. Alaska, for example, provides that a trust protector is not a fiduciary, unless otherwise provided by the terms of the trust instrument.⁵ Illinois, on the other hand, specifically recognizes the role of the trust protector and provides that a trust protector is a fiduciary, unless otherwise provided in the trust instrument.⁶

Trust Protector's Standard of Conduct

If the trust protector is a fiduciary, the minimum standard by which the trust protector's conduct is judged is typically whether she has acted in good faith, and in the best interest of the beneficiary and the purposes of the trust. Whether the settlor can modify this standard of conduct, perhaps by limiting the trust protector's liability to only include a breach arising from her actions taken in bad faith, or due to willful misconduct or even gross negligence, is a separate question.

It is essential that the trust instrument indicate clearly whether and under what circumstances the trust protector will be acting in a fiduciary capacity. If the trust protector is not to be held to a fiduciary standard, that should also be stated explicitly and the limitation must be in accordance with the governing law. The trust instrument should also specify

whether the required standard of conduct is good faith, reasonableness, or some other standard. Special situations that involve the exercise of professional judgment or expertise may require a higher standard. In all instances, an understanding of what is and is not permissible under the applicable state law is essential.

The flexibility of having a trust protector is enhanced by the trust protector's ability to function outside of the typical trustee limitations and liabilities. This doesn't mean there should be zero accountability; rather, full accountability with limited liability. If the trust protector has acted in a manner envisioned by the settlor using powers specifically granted by the settlor, the trust protector should be immune from liability.

CONCLUSION

Naming a trust protector can offer very broad, or very narrow, flexibility in the administration of a trust. However, the current uncertainty in the legal status of a trust protector and the legal effects of the trust protector's actions should give pause to those who think a trust protector is a magic bullet. This lack of certainty places additional responsibility on the drafting attorney to be thoughtful in drafting the necessary trust provisions to be clear in defining the scope of authority, the status as a fiduciary, any applicable duties, and limiting the liability of the trust protector. When defined in a way that is appropriate for your particular wealth transfer plan, the appointment of a trust protector can provide the desired flexibility for trusts expected to last generations.

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¹ UNIF. TRUST CODE § 808(b)-(d) cmt. (amended 2010). The following states have adopted the UTC: Alabama, Arizona, Arkansas, District of Columbia, Florida, Kansas, Kentucky, Maine, Maryland, Massachusetts, Michigan, Minnesota, Mississippi, Missouri, Montana, Nebraska, New Hampshire, New Jersey, New Mexico, North Carolina, North Dakota, Ohio, Oregon, Pennsylvania, South Carolina, Tennessee, Utah, Vermont, Virginia, West Virginia, Wisconsin and Wyoming.

² The following non-UTC states permit the use of trust protectors: Alaska, Delaware, Georgia, Illinois, Indiana, Nevada, Rhode Island, South Dakota, Texas and Washington.

³ *Robert T. McLean Irrevocable Trust v. Davis*, 283 S.W.3d 786 (Mo. Ct. App. 2013).

⁴ UNIF. TRUST CODE § 105.

⁵ Alaska Stat. Ann. § 13.36.370.

⁶ 760 ILCS §§ 16.3, 16.7.